Canada. Office of the Auditor General.
Tax expenditures and tax compliance costs.

(Discussion paper no. 16)

Office of the
Auditor General
of Canada

Bureau du
vérificateur général
du Canada

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TAX EXPENDITURES AND TAX COMPLIANCE COSTS

by

Barry Elkin

JUNE 1983

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INTRODUCTION

Taxpayers involved in administering tax laws and taxpayers involved in complying with tax laws have from time to time commented on the obscure issues surrounding tax expenditures and tax compliance costs. Progress to date toward bringing this discussion into the open has been academic.

I am the first to admit that there are problems in defining, measuring and evaluating. Debate about whether this should be done could go on forever. Certainly, to solve the problem of dealing with the issues will require a new approach. But certainly there are innovators amongst us. Innovation carries with it risks and rewards. Risk-takers are rewarded with handsome payoffs .... when rewarded. But they also may meet with failure. On balance, I believe that shying away from the issues is a risk we shouldn't take. I've tried to present the issues in as straightforward a manner as possible.

I would like the questions I raise to bring you into the discussion. I also want to lead you to the question of how to deal with the issues.

TAX EXPENDITURES

Canada's tax system, concurrent with raising revenue, is used to pursue certain social, political and economic goals. Tax legislation contains special provisions such as exemptions, deductions, credits, rebates, exclusions, preferential rates or postponements of income tax. These special provisions provide tax relief for defined transactions and for certain individuals. The loss of revenue attributed to tax relief is like a direct subsidy and is viewed as an indirect expenditure or tax expenditure.

The precise definition of what constitutes a tax expenditure is currently being debated. There are those who view taxes forgone related to, say, personal exemptions and untaxed homemaker services as tax expenditures. I tend to view this sort of argument as academic. While I can appreciate the academic arguments, I believe that the issue demands a greater sense of urgency.

Although it would be nice to have an exact definition of tax expenditure, I believe it is important to begin dealing with the issue. Refinements can take place as progress is being made.

In very general terms, I think we should ultimately concern ourselves with the reasons for the particular tax expenditure and whether in fact it accomplishes its stated purpose. I concur with the view expressed by Michel Bergeron in Canadian Public Policy, that "tax expenditures should be analysed as to their capacity to meet certain objectives".

The Department of Finance has recognized the importance of tax expenditures and has produced three publications on the subject. In December 1979 the Department published "Government of Canada Tax Expenditure Account", a conceptual analysis and account of tax preferences in the federal income and commodity tax systems. In December 1980 it published "Government of Canada Tax Expenditures Account", an account of tax preferences in the federal income and commodity tax systems, 1976-1980 and, in November 1981, "Analysis of Federal Tax Expenditures for Individuals".

The importance of tax expenditures and the need to evaluate their effectiveness is made quite clear by Finance. The December 1979 publication states:

> Tax expenditures are a means by which the government can pursue public policy objectives and, as such, they can be viewed in most cases as alternatives to direct budget outlays or other policy instruments. Indeed, both tax expenditures and direct budget outlays are used to meet many of the same objectives .... Also, because both tax and direct expenditures are used for many of the same objectives, it is desirable that information on both types of policy instruments be readily available for purposes of informed and rational policy formulations and decision making.

The November 1981 publication goes on to say:

It is clear that the existence of tax expenditures is important. For some purposes the tax system is a legitimate tool to address social and economic goals. However, it is important to monitor the effects and distribution of the tax expenditure benefits to determine if their aggregate impact is equitable and desirable. In addition, continuous evaluations of tax expenditures are required to isolate those provisions that, through time, have become ineffective as tools of public policy.

To bring us into the present, I quote from the Minister of Finance's 19 April 1983 Budget Speech:

> Strong, lasting recovery and the significant reduction of unemployment we need will come primarily through the private sector: the economy's main engine of growth. I shall accordingly introduce measures to strengthen the financial position of Canadian businesses, farmers and fishermen, improve their capacity to undertake productive investment and assist them in obtaining more equity capital.
>
> For recovery to be sustained in Canada, and for real growth of our incomes and our living standards to resume, we must raise our sights beyond the period immediately ahead of us. A broad national effort is required over the remaining years of the decade to make sure that Canada remains one of the most productive, competitive and prosperous economies in the industrialized world. Our major trading partners will continue to move forward. To remain competitive,

Canada therefore has no choice but to move forward too. We must put our businesses and our workers in a position to meet or beat the competition.

To assist in accomplishing his policy objective, one of the tools used by Mr. Lalonde was a tax incentive or tax expenditure program. Income taxes will be "rebated" to qualifying taxpayers in return for entering into defined economic transactions. Each incentive was designed to support a certain economic end. In addition to providing economic benefit to the recipient, it was designed to provide economic benefit to Canadians as a whole. If the incentive provides economic benefit to the recipient only, it will not fulfil its purpose.

A quick calculation indicates that the incentives introduced in this budget relating to personal and corporate income taxes represent 1983-84 tax expenditures of at least $330 million, rising to more than $1.1 billion in fiscal 1986-87. Over the four years they total approximately $3.2 billion. (This is in addition to the incentives previously in place).

I leave it to you to decide what the effects will be if this program fails. I also leave you with two questions:

- Should an important program such as this not be subject to monitoring and evaluation?

- Should the Minister of Finance be accountable only on election days?

TAX COMPLIANCE COSTS

"Small business organizations as well as others have urged me to simplify the tax system and thereby reduce the paper burden and compliance costs it imposes on taxpayers."

Honourable Marc Lalonde
Minister of Finance
19 April 1983 Budget Speech

A self-assessing tax system such as Canada's is a "partnership" between taxpayers and their taxing authorities. They share the responsibility (not necessarily equally) of raising revenue for the common good. Each incurs costs in fulfilling his or her share of the responsibility. Taxpayers, in addition to providing direct funds -- better known as income taxes -- provide indirect funds by incurring costs to comply with tax statutes. These out-of-pocket costs, simply stated, are compliance costs.

In addition to the out-of-pocket costs, the resources directed to compliance requirements cause lost opportunities. Such lost opportunities are also really compliance costs. Opportunity costs are faster-moving targets than out-of-pocket costs, but even if they are non-quantifiable they are an element to be dealt with.

If current trends in Canada and the U.S. are any indication of what lies ahead for taxpayers, the requirements (with their associated costs) to provide

information to taxing authorities will continue to rise. Enforcement costs can be moved from taxing authorities to taxpayers. This "conversion" of enforcement costs to taxpayer compliance costs may have the effect of artificially increasing the tax departments' economy, efficiency and effectiveness indicators.

As Richard M. Bird pointed out in an article in the Canadian Tax Journal, "Even good cost-revenue studies do not in themselves provide answers to the questions facing those concerned with designing and implementing tax policies. But they can provide information that may, when judiciously used, help policy makers and managers find answers that may be better than would otherwise be possible."

Do we need better answers?

CONCLUSION

Tax legislation is far-reaching. It not only reaches into pockets, but its tentacles reach into every aspect of Canadian economic and social life. It requests and disseminates information; it distributes and redistributes income; it causes countless other actions and reactions.

Significant policies and programs are introduced through the tax system, and we have no idea if they are accomplishing their goals. The system continues to plod along with more unknown than known costs.

Micro reviews of macro programs could produce incorrect findings. Put another way, if we look at the vegetables and find them satisfactory, look at the chocolate bar and find it outstanding and then look at the scotch and find it's the finest money can buy, do we conclude that together they make a good meal?

As the Auditor General said in his 1982 Report, "The real advantage can be stated very simply: the comprehensive auditor turns his attention from the fly in the soup to the quality control -- or lack of it -- in the kitchen."

The fact that it may be hot in the kitchen is not necessarily an excuse for staying out.

Tax Expenditures

Introduced in 19 April 1983 Budget

Relating to Personal and Corporate Income Taxes

	1983-84	1984-85	1985-86	1986-87
		(millions of dollars)		
Personal Income Tax				
Increase in Child Tax Credit[1]	25	85	90	95
Modification of RHOSP	5	60	60	-
Indexed Security Investment Plan	-	-	100	300
Special Recovery Refundable Investment Tax Credit	-	35	40	45
Special Recovery Share Purchase Tax Credit	-	25	35	40
Change rules for claiming Investment Tax Credit	-	15	25	25
Corporate Income Tax				
Change rules for claiming Investment Tax Credit	175	255	300	350
Proposals for changes in R & D tax incentives	-	110	170	195
Special Recovery Refundable Investment Tax Credit	80	80	85	35
Special Recovery Share Purchase Tax Credit	25	35	40	40
Extend 7 percent Investment Tax credit to heavy construction equipment	20	30	35	40
	330	730	980	1,165

[1] It could be argued that this is not a tax expenditure.

Source: The Fiscal Plan - 19 April 1983

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